

Senate Bill 333

2008 Amendments to the Revised Uniform Principal and Income Act

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Montana adopted the most recent version of the Uniform Principal and Income Act in 2003. That act provides rules for trustees concerning the allocation of trust income and expenses. The allocations affect all trusts.

For example, it is common for a trust to provide that income is to be distributed to a surviving spouse during the spouse's lifetime and principal is to be distributed after the death of the surviving spouse to the couple's children. When the trust receives rent from real estate, interest from a bond, and dividends from a stock, the Act generally provides that the income beneficiary (the surviving spouse in this example) is to receive these distributions. When the trustee sells the real estate, bond, or stock, the Act generally provides that the proceeds are to be reinvested in the trust for ultimate distribution to the remainder beneficiaries (the children in this example) upon the trust's termination.

In 2008, the national Uniform Law Commission proposed two changes to the revised Uniform Principal and Income Act. Senate Bill 333 would incorporate those two changes in Montana law.

Section 1 of Senate Bill 333 reflects the current policy of the Internal Revenue Service regarding the federal **estate** tax marital deduction. Section 1 updates MCA § 72-34-441 to ensure the federal **estate** tax marital deduction when an Individual Retirement Account (IRA) is a trust asset.

Section 2 of Senate Bill 333 clarifies technical language regarding withholding of distributions from partnerships, limited liability companies, and other closely-held businesses. It modifies MCA § 72-34-452 to provide a formula to allocate income from the business interest between the trust and the income beneficiary. Under the formula, the trust is allocated a sufficient portion of the income in order to pay income taxes attributable to the business interest.

To date, the changes have been adopted in 25 states including North Dakota, South Dakota, and Idaho.

Neither section affects federal or state **income** taxation. Also, Senate Bill 333 does not affect Montana **estate** taxation because Montana no longer has an estate tax.

Senate Bill 333 will benefit Montanans by ensuring the federal estate tax marital deduction for a trust which holds an IRA. It will also benefit Montana trust beneficiaries by providing trustees a formula for the allocation of income among trust beneficiaries.

A summary of these 2008 Amendments prepared by the National Conferences of Commissioners on Uniform Law State Laws is found on the reverse side of this document.



SUMMARY

Uniform Principal and Income Act

2008 Amendments

At its Annual Meeting in 2008, the Uniform Law Commission approved amendments to Sections 409 and 505 of the Uniform Principal & Income Act (UPIA), to implement technical changes related to developments and interpretations relating to tax matters. The amendments are as follows:

Section 409: Sometimes a person leaves his or her IRA or similar retirement plan to a trust for his or her spouse instead of to the spouse outright. This is not uncommon when the person has children by a prior marriage or has a spouse who is incapable or unwilling to manage money. Qualifying this trust for the federal estate tax marital deduction prevents estate tax from being incurred until the surviving spouse dies. Revenue Ruling 2006-26 sets forth the Internal Revenue Service's view of when a Plan payable to a trust will qualify for the marital deduction. The spouse must have the right to require that the Plan's income be distributed to the spouse. To the extent that the Plan earns income (as defined in the UPIA), the trustee must pay to the spouse any distributions received from the Plan. This IRS ruling directly criticizes the UPIA's formula for allocating IRA distributions between principal and income. The changes to this section are designed to bring the UPIA into compliance with the IRS' position, to ensure that the trust qualifies for the marital deduction to minimize estate taxes in accordance with the decedent's plans. These changes also address the policies underlying the ruling—that might cause concern in other situations.

Section 505: It is not uncommon for trusts that are required to pay income to a beneficiary to own an interest in a closely-held business ("entity"). Often, the trust needs to report its share of the entity's income, whether or not the trust actually receives all of this income. A limited liability company taxed as a partnership is a common example of such an entity. Many such entities distribute to their owners only enough income to enable the owners to pay their tax obligations. They commonly reinvest the rest of the income in business operations. This strategy works well when the owners are individuals, but it can cause problems when the owners are mandatory income trusts, as described below. Take, for example, a trust that has a 40% combined federal and state income tax rate and it is to be taxed on \$100 of the entity's income. The entity distributes \$40 to the trust to fund the tax obligation. If the trust is required to distribute the full \$40 to the beneficiary, the trust will be taxed on \$60 of income (\$100 minus the \$40 that was distributable to the beneficiary), but will have no money remaining to pay its taxes. The beneficiary would be liable for the taxes on the \$40 distribution.

UPIA section 505 provides a formula for calculating how much the trust needs to distribute and how much it can use to pay taxes. The existing language is ambiguous and has led to litigation. The proposed change clarifies that the trust will keep enough money to pay its taxes and distribute the balance of the income to the mandatory income beneficiary.

The IRS would not provide an official opinion about the proposed changes until after they were adopted by the Uniform Law Commission. However, the two people who would most influence the IRS' position have informally indicated that these changes should be acceptable.

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